recoverable from the USF would not increase if a carrier were unable to control its costs. The carrier would therefore have a greater incentive to control the cost of delivering telephone service.

Second, the current USF rules count loop costs on a study area basis. Because study areas are often very large,[31] this scheme does not allow regulators to apply the subsidy only where it is needed. In other words, applying the system on a study-area basis results in LECs receiving support for areas in which their loop costs do not exceed the national average and receiving inadequate support in areas where their loop costs do exceed the national average. The Commission should therefore require that the proxy model track costs in small geographic units, such as CBGs or wire centers

Finally, the current USF is not administered by a neutral third party. As MCI has correctly observed, the National Exchange Carrier Association ("NECA"), which administers the USF, is owned and controlled by the ILECs and is therefore not neutral.[32] The Commission should therefore issue a request for proposal for fund administration and choose the most appropriate neutral third party to administer the USF.[33]

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31 A study area is the territory within a state served by a particular carrier. In many cases study areas are the size of an entire state.

32 See Reply Comments of MCI at 16.

33 See e.g., Comments of ALTS at 19; Comments of the Wisconsin PSC at 19.

28. What are the potential advantages and disadvantages of basing the payments to competitive carriers on the book costs of the incumbent local exchange carrier operating in the same service area?

ANSWER:

The central disadvantage of basing the payments to competitive carriers on the book costs of the ILEC operating in a particular area is that the ILEC may not be the most efficient provider of telephone service. Indeed, given the historical circumstances of monopoly service and regulatory distortions, the ILEC is very likely not the most efficient provider. If this is the case, a subsidy level (i.e., the difference between the "cost" of providing service and the affordable rate) that is based on the ILEC's book costs will be higher than necessary. An unnecessarily high subsidy is damaging to competition because it increases the required contribution to the USF which all telecommunications carriers are required to make. Like any other tax increase levied on a particular industry, higher than necessary universal service contributions will reduce society's investment in and consumption of telecommunications services.

In addition, relying on reported costs would make it more difficult for regulators to target the federal high cost subsidy. This is because most ILECs report their costs on a study area-wide basis. It is therefore impossible to determine from such cost data the particular areas within a study area which are characterized by high costs. As a result, carriers operating in areas that are not high cost would be oversubsidized while

carriers in areas which are high cost would not receive a large enough subsidy.[34]

Some parties will likely argue that relying on book costs is a more "accurate" reflection of the cost of providing service. But it is far from clear that the reported costs of an ILEC are actually an accurate reflection of even the ILEC's cost of providing telephone service.

29. Should price cap companies be eligible for high-cost support, and if not, how would the exclusion of price cap carriers be consistent with the provisions of section 214(e) of the Communications Act? In the alternative, should high-cost support be structured differently for price cap carriers than for other carriers?

ANSWER:

Denying price cap carriers eligibility to receive universal service subsidies would make sense in areas where the incumbent faces little or no competition and where the universal service subsidy is based on its book costs. With no significant competitor or potential competitor, the ILEC would not have a market-based incentive to control its costs. Moreover, the increased incentive created by price caps for the ILEC to control its costs would be reduced because increased costs could simply be reported and reimbursed through the subsidy program.

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34 See Amendment of Part 36 of The Commission's Rules And Establishment of a Joint Board, Notice of Proposed Rulemaking and Notice of Inquiry, CC Docket No 80-286 at ¶ 75 n. 91 (listing study areas not qualifying for USF support but that nonetheless likely contain high cost areas).

This problem could be significantly reduced, however, if the Commission were to adopt a forward-looking proxy cost model as the basis for determining the cost of providing service. Such models increase carriers' incentive to control their costs because they reflect the cost of providing service over a state-of-the-art-network.[35] In this way, a proxy model operates much like price caps because, as mentioned, an ILEC would theoretically not be able to recover increased costs caused by inefficiencies. Thus if the Commission decides, as it should, to base costs on a proxy model, there appears to be no reason why it should not allow price cap LECs to receive universal service subsidies.

30. If price cap companies are not eligible for support or receive high-cost support on a different basis than other carriers, what should be the definition of a "price cap" company? Would companies participating in a state, but not a federal, price cap plan be deemed price cap companies? Should there be a distinction between carriers operating under price caps and carriers that have agreed, for a specified period of time, to limit increases in some or all rates as part of a "social contract" regulatory approach?

ANSWER:

As mentioned above, under a proxy model approach, all carriers should be equally eligible to apply to receive federal universal service support subsidies.

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35 In the Interconnection proceeding, the Commission has determined that forward-looking cost methodologies are the most appropriate bases for determining the cost of providing telecommunications services under the 1996 Act. See FCC News Release, "Commission Adopts Rules To Implement Local Competition Provisions Of Telecommunications Act of 1996 (CC Docket No. 96-98)" at 2 ("Interconnection News Release").

Proxy Models

35. US West has stated that an industry task force "could develop a final model process utilizing consensus model assumptions and input data." US West comments at 10. Comment on US WEST's statement, discussing potential legal issues and practical considerations in light of the requirement under the 1996 Act that the Commission take final action in this proceeding within six months of the Joint's Board's recommended decision.

ANSWER:

TCI opposes US WEST's proposal that an industry task force should be established to choose a consensus model. As the experience of the parties that initially developed the Benchmark Cost Model ("BCM") demonstrates,[36] parties with conflicting business interests will almost inevitably disagree on the characteristics of the model. Those disagreements will likely pit ILECs, who stand to receive the largest portion of the subsidy flow and who are interested in setting costs at a high level so that they can recover their "historical" costs, against new entrants, who seek to establish the proxy costs based on TS-LRIC.

It is especially unlikely that the parties will reach a consensus within the statutory deadline for concluding this proceeding (within 15 months of the passage of the 1996 Act). The Commission should, therefore, offer parties ample opportunity to comment on the proposed proxy models and then choose one, with

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[36] MCI, apparently unable to reach agreement with the other parties with whom it co-sponsored BCM, US WEST, Sprint and NYNEX, has now developed its own model with AT&T, the so-called Hatfield Model.

any modifications it deems appropriate. Any other approach would invite delay and increase the risk that the statutory deadline will not be met.

41. How should support be calculated for those areas (e.g., insular areas and Alaska) that are not included under the proxy model?

ANSWER:

It is TCI's understanding that at least US West has now obtained cost information for Alaska, the Virgin Islands, Puerto Rico and Micronesia.[37] In areas for which data are still not available, however, the Commission should base the cost of providing service on the book costs reported by the ILEC. When the relevant data become available, the transition should be made to proxy-based cost estimates.

42. Will support calculated using a proxy model provide sufficient incentive to support infrastructure development and maintain quality service?

ANSWER:

It is possible that, in a proxy-cost environment, ILECs that do not face competition will try to reduce the quality of service provided in their regions as a way of lowering their costs and increasing profits. The most obvious solution to this problem is for the Commission to establish the preconditions for local competition as quickly and effectively as possible. But until

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37 See Letter from Glenn Brown, Executive Director-Public Policy, US West Inc. to William Caton, Secretary, Federal Communications Commission, ex parte, at 2 (June 14, 1996).

competition develops, the Commission should rely on the states to establish safeguards against service degradation.

43. Should there be recourse for companies whose book costs are substantially above the costs projected for them under a proxy model? If so, under what conditions (for example, at what cost levels above the proxy amount) should carriers be granted a waiver allowing alternative treatment? What standards should be used when considering such requests?

ANSWER:

Carriers with book costs substantially above the costs projected for them under a proxy model should be permitted to receive waivers for the application of the proxy-based subsidy level. The Commission should grant such waivers, however, only where the carrier can demonstrate that its costs are 150% of the projected proxy level and that such excess can be justified as the result of prudent investment.

45. Is it appropriate for a proxy model adopted by the Commission in this proceeding to be subject to proprietary restrictions, or must such a model be a public document?

ANSWER:

It is inappropriate for the Commission to adopt a proxy model in this proceeding that is subject to proprietary restrictions. Although presumably the applicable restrictions would permit interested parties to review and analyze the model in question in the context of this proceeding, proprietary restrictions would nonetheless be destructive.

46. Should a proxy model be adopted if it is based on proprietary data that may not be available for public review?

ANSWER:

Before the Commission implements a proxy model, which will have the significant and enduring impact on the regulation of the

telecommunications industry, it must offer interested parties the maximum opportunity possible to review and comment on that mechanism. A prohibition on public review of the proxy model would be unsound policy and could well violate the requirements of the Administrative Procedure Act.[38]

Competitive Bidding

49. How would high-cost payments be determined under a system of competitive bidding in areas with no competition?

ANSWER:

TCI does not support the adoption of a bidding system for determining high-cost payments at this time because it is unlikely that there will be enough local competition in the near future to make subsidy auctions worthwhile. First, although there will soon be new entrants into the local market, many of those entrants will operate on a resale basis. Pure resellers cannot qualify under Section 214(e) to receive federal subsidies.[39] Moreover, those new entrants that have some

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38 See National Black Media Coalition v. FCC, 791 F.2d 1016 (D.C. Cir. 1985 (overturning FCC decision to abandon minority preference policy for broadcast licenses because, in reaching its decision, the Commission relied on inadequately disclosed data in violation of Section 4 of the Administrative Procedure Act). See also United States Lines v. Federal Maritime Comm'n, 584 F.2d 519, 534 (D.C. Cir. 1978) ("we have required information in agency files or reports identified by the agency as relevant to the proceeding to be disclosed to the parties for adversarial comment").

39 See 47 U.S.C. § 214(e)(1)(A) (requiring each eligible carrier to provide the subsidized services over "its own facilities or a combination of its own facilities and resale of another carrier's facilities").

facilities will likely rely heavily on resale to deliver all core services. Such entities may not be willing to fulfill the carrier of last resort obligations imposed on the eligible telecommunications carriers.[40] Finally, the more dependent a carrier is on resale, the less able it will be to underbid the incumbent because the costs of the incumbent will be passed onto to a reseller for all the network elements resold. In many cases, therefore, there may not be a sufficient "market" in the near term for the auctioned rights.

Nonetheless, if the Commission were to adopt a bidding system, it could do so as an overlay to a proxy model approach. Thus, in areas where bidding would not be appropriate (i.e., in markets lacking facilities-based competitors) the cost of providing service would be established by proxy. In areas where bidding would be appropriate, carriers deemed eligible to receive universal service subsidies under Section 214(e) would have the opportunity to bid on the "cost" of providing service in an area. If the lowest bid were lower than the cost as determined by the proxy model, then that amount would constitute the applicable cost level for the relevant geographic area.

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40 See id.

50. How should a bidding system be structured in order to provide incentives for carriers to compete to submit the low bid for universal service support?

ANSWER:

Creating the incentive for carriers to bid low is probably the most difficult aspect of implementing a bidding system. The problem is that, since all carriers will be subject to the subsidy set based on a low cost bid, no carrier is likely to gain a competitive advantage by bidding low. This would be the case if the carriers believed, as may well be the case, that the direct benefits of receiving a larger subsidy outweighed their individual share of the increased costs of a higher required contribution to the federal subsidy fund.

There are, however, possible mechanisms the Commission could implement in order to increase carriers' incentives to underbid each other. For example, the Commission could offer the low bidding party an extra subsidy which other carriers would not receive. Such incentive payments would, however, add to the complexity and cost of the bidding scheme. When adequate levels of competition have developed to warrant serious consideration of a bidding scheme, the Commission must determine whether the reduction in the size of the subsidy pool created by a bidding mechanism exceeds the total cost, including the incentive subsidy or other similar mechanism, of operating the bidding system.

52. What safeguards should be adopted to ensure adequate quality of service under a system of competitive bidding?

ANSWER:

Although it is possible that carriers subject to a bidding scheme will have the incentive to degrade service in order to

increase profits, such incentives should be diminished where carriers face competition (which they will, at least to some degree, in a bidding environment). In any case, the protections described in response to question 42 above may be used to diminish these opportunities.

53. How is collusion avoided when using a competitive bid?

ANSWER:

As mentioned above, it may be possible for the Commission to provide carriers with the incentive to bid low by granting the low bidder an extra subsidy payment. If the payment were large enough, parties would forgo opportunities for collusion. Direct prohibitions, such as those used by the FCC in spectrum auctions and those found in the antitrust laws, can also be used.

54. Should the structure of the auction differ if there are few bidders? If so, how?

ANSWER:

Like any other economic market, it would appear that the likelihood of collusion would increase as the number of bidders decreases. It may therefore be necessary for the Commission to increase the incentive payment in situations where there are fewer bidders.

55. How should the Commission determine the size of the areas within which eligible carriers bid for universal service support? What is the optimal basis for determining the size of those areas, in order to avoid unfair advantage for either the incumbent local exchange carriers or competitive carriers?

ANSWER:

Determining the proper geographic units for bidding purposes is yet another difficult aspect of the bidding approach. On the

one hand, bidding should not be conducted for an area that includes a wide diversity of cost characteristics (i.e., some high cost areas and some low cost areas). This is because the subsidy set for such an area would not allow the support program to be adequately targeted. On the other hand, requiring bidding for very small geographic units would increase the number of auctions and also the cost of administering and participating in the bidding system. Again, it may be possible to solve this problem. Given the current lack of competition in the local telephone market, however, the costs of solving this and other aspects of the bidding scheme outweigh the benefits such a scheme may deliver at this time.

SLC/CCL

69. If a portion of the CCL charge represents a subsidy to support universal service, what is the total amount of the subsidy? Please provide supporting evidence to substantiate such estimates. Supporting evidence should indicate the cost methodology used to estimate the magnitude of the subsidy (e.g., long-run incremental, short-run incremental, fully-distributed).

ANSWER:

Whether viewed as a subsidy or not, there is no question that the CCL charge is an inefficient means of recovering the costs of the local telephone network.[41] The Part 36 jurisdictional separations rules allocate 25 percent of non-traffic sensitive loop costs[42] to the interstate jurisdiction.

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41 The Commission has announced that it will soon commence an access charge proceeding. See Interconnection News Release at 2.

The CCL charge recovers a substantial portion[43] of these non-traffic sensitive loop costs through traffic sensitive per-minute usage charges to long distance carriers. Thus, the price of each interstate toll call is used to recover the loop cost of connecting subscribers to the local network. The more interstate toll calls a subscriber makes, the higher the contribution paid by that subscriber.

The problem with characterizing this contribution as a subsidy is multifold. First, the historical legal requirement to separate interstate and intrastate costs bears no relation to the economic services provided. Further, it can and has been debated whether access to the network (local and/or toll) is itself an economic service that can be priced discretely from local and/or network usage.

It is in any event clear that the fact that the CCL charge is usage sensitive creates substantial inefficiency by recovering non-traffic sensitive costs through usage sensitive pricing. In order to accurately communicate the price of a service to consumers and market entrants (potential and actual), the pricing of the service should reflect the manner in which costs are incurred. In other words, non-usage sensitive loop costs should

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42 Non-traffic sensitive loop costs primarily include those costs incurred to connect subscribers to the network, i.e., local loop.

43 Part of the non-traffic sensitive loop costs allocated to the interstate jurisdiction are recovered through the SLC, a charge assessed to local telephone subscribers on a per-line (non-usage sensitive) basis.

not be recovered thro igh usage sensitive rates. To encourage efficient use of the network by subscribers, non-usage sensitive costs should be reco ered with flat fees.

Further, substa tial economic inefficiency results from the effective imposition of the CCL charge on long distance carriers. This is because asse sing the CCL charge on IXCs rather than directly on subscrib rs understates the charge for connecting subscribers to the l cal loop and overstates the charge for long distance service. E d users are thereby uneconomically encouraged to add ad itional lines (connections to the local exchange network) an to make fewer long distance calls. Market signals to both the local exchange and toll markets are skewed. Thus, even if the CC charge were a flat fee charged to IXCs, economic inefficienc y would result because costs would not be recovered from the c ost causer.

However, while the CCL charge in the aggregate may be correctly termed a subsidy tending to reduce the price of purchasing connecti ns to the local network, it is not an explicit subsidy an thus distorts market signals. Further, it tends to reduce the price of access to the network and to inflate the price of long d stance service for <u>all</u> subscribers, and thus it is in no way tar geted to high-cost areas or to subscribers in need of assistance.[44] There is no particular reason to believe that subscribers re sident in high-cost areas make fewer toll

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44 <u>See Notice</u> at ¶ 113.

calls then other subscribers. To the extent toll usage patterns for these subscribers do not materially vary from the norm, then no subsidy to high cost areas can be said to occur -- only between subscribers with high toll usage and those with low toll usage. In fact, as described above, the CCL is an implicit "subsidy" resulting from the required recovery of non-traffic sensitive loop costs through traffic sensitive pricing. As part of this proceeding, the Commission therefore should undertake access charge reform consistent with economic efficiency principles and the new competitive environment, as discussed below in question 70

70. If a portion of the CCL charge represents a contribution to the recovery of loop costs, please identify and discuss alternatives to the CCL charge for recovery of those costs from all interstate telecommunications service providers (e.g., bulk billing, flat rate/per-line charge).

ANSWER:

As described above, the CCL charge does make a contribution to the recovery of loop costs. However, merely continuing to load long distance rates with this subsidy is economically inefficient and likely unsustainable in the context of local loop competition. The SLC, or some other suitable fixed, subscriber charge, should therefore be increased to replace the CCL. It is important to point out that the amount that an increased SLC would recover should be significantly smaller than the amount currently recovered by the CCL charge because loop costs should be based on TS-LRIC and should therefore exclude costs caused by historical inefficiencies ostensibly recovered by the CCL charge. In any case, mandating that the CCL charge be assessed on

subscribers in this way not only accurately reflects the cost of connecting subscribers to the network, but also avoids distorting the price and efficient use of the long distance network. Any concerns as to the local rate "sticker shock" can easily be addressed by shifting the CCL to the SLC over an appropriate transition period.[45]

Low-Income Consumers

71. Should the new universal service fund provide support for the Lifeline and Linkup programs, in order to make those subsidies technologically and competitively neutral? If so, should the amount of the lifeline subsidy still be tied, as it is now, to the amount of the subscriber line charge?

ANSWER:

As with the current USF program, both the Lifeline and Linkup programs are administered by NECA. Specifically, NECA administers a separate Lifeline/Linkup pool which certain long distance carriers contribute to on a flat-rate, per-line basis.[46]

There are three essential problems with this scheme. First, as mentioned above, NECA is owned and controlled by the ILECs and

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45 There is fairly broad support among the commenting parties for a transition period to raise the SLC. See Comments of USTA at 18; Comments of Southwestern Bell at 4-5; Comments of BellSouth at 10-12; Comments of Bell Atlantic at 11-12; Comments of Compuserve at 6-7; Comments of Time Warner at 19-20; Comments of MFS at 22; Reply Comments of GTE at 21-22.

46 See Amendment of Part 69 of the Commission's Rules Relating to the Assessment of Charges for the Universal Service Fund and Lifeline Assistance, Memorandum Opinion and Order, 4 F.C.C.R. 6134 at ¶ 5 (1989) ("Lifeline Order"); 47 C.F.R. §§ 69.116, 69.117. In fact, only those IXCs with .05% or more of the presubscribed lines nationwide contribute to the Lifeline/Linkup program. See Lifeline Order at ¶ 5.

is not an independent third party. The Commission should therefore require that the independent party chosen to administer the universal service fund also administer the Lifeline and Linkup fund. If such administration is more efficiently accomplished by combining the Lifeline/Linkup fund with the USF, then this should be done. Second, only ILECs are eligible to receive reimbursement from the Lifeline/Linkup fund. The Commission must therefore ensure that all local exchange carriers deemed eligible to receive the universal service subsidy under Section 214(e) are able to receive the Lifeline/Linkup subsidy as well. Finally, as with other aspects of the federal subsidy system, the Lifeline Linkup program must be changed so that all carriers providing interstate services, not just long distance carriers, contribute to the program on an "equitable and nondiscriminatory basis" as required by Section 254(d).[47]

As to whether the Lifeline subsidy should continue to be tied to the level of the SLC, TCI believes that this is a sound approach. The Lifeline subsidy would likely need to increase correspondingly with increases in the SLC.

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[47] 47 U.S.C. § 254(d).

III. CONCLUSION

The Joint Board should recommend and the Commission adopt rules for universal service consistent with these comments.

Respectfully submitted,

Philip L. Verveer
Sue Blumenfeld
Thomas Jones

WILLKIE FARR & GALLAGHER
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20036
(202) 328-8000

ATTORNEYS FOR TELE-COMMUNICATIONS, INC.

August 2, 1996

CERTIFICATE OF SERVICE

I, Thomas Jones, do hereby certify that on this 2nd day of August, 1996, copies of the foregoing "Comments of Tele-Communications, Inc." were delivered by first class mail, postage prepaid, or hand delivered to the following parties:

HAND DELIVERED

The Honorable Reed E. Hundt, Chairman
Federal Communications Commission
1919 M Street, N.W. -- Room 814
Washington D.C. 20554

The Honorable Rachelle B. Chong, Commissioner
Federal Communications Commission
1919 M Street, N.W. -- Room 844
Washington D.C. 20554

The Honorable Susan Ness, Commissioner
Federal Communications Commission
1919 M Street, N.W. -- Room 832
Washington D.C. 20554

The Honorable James H. Quello, Commissioner
Federal Communications Commission
1919 M Street, N.W. -- Room 802
Washington D.C. 20554

Deborah Dupont, Federal Staff Chair
Federal Communications Commission
2000 L Street, N.W., Suite 257
Washington DC 20036

Mark Nadel
Federal Communications Commission
1919 M Street, N.W., Room 542
Washington D.C. 20554

Jeanine Poltronieri
Federal Communications Commission
2000 L Street, N.W., Suite 257
Washington DC 20036

Jonathan Reel
Federal Communications Commission
2000 L Street, N.W., Suite 257
Washington D.C. 20036

Gary Seigel
Federal Communications Commission
2000 L Street, N.W., Suite 812
Washington, DC 20036

Pamela Szymczak
Federal Communications Commission
2000 L Street, N.W., Suite 257
Washington DC 20036

Whiting Thayer
Federal Communications Commission
2000 L Street, N.W., Suite 812
Washington DC 20036

Alex Belinfante
Federal Communications Commission
1919 M Street, N.W.
Washington DC 20554

Larry Povich
Federal Communications Commission
1919 M Street, NW
Washington DC 20554

FIRST CLASS MAIL

The Honorable Julia Johnson, Commissioner
Florida Public Service Commission
Capital Circle Office Center
2540 Shumard Oak Blvd.
Tallahassee, FL 32399-0850

The Honorable Kenneth McClure, Vice Chairman
Missouri Public Service Commission
301 W. High Street, Suite 530
Jefferson City, MO 65102

The Honorable Sharon L. Nelson, Chairman
Washington Utilities and Transportation Commission
P.O. Box 47250
Olympia, WA 98504-7250

The Honorable Laska Schoenfelder, Commissioner
South Dakota Public Utilities Commission
500 E. Capital Avenue
Pierre, SD 57501

Martha S. Hogerty
Public Counsel for the State of Missouri
P.O. Box 7800
Harry S. Truman Building, Room 250
Jefferson City, MO 65102

Paul E. Pederson, State Staff Chair
Missouri Public Service Commission
P.O. Box 360
Truman State Office Building
Jefferson City, MO 65102

Eileen Benner
Idaho Public Utilities Commission
P.O. Box 83720
Boise, ID 83720-0074

Charles Bolle
South Dakota Public Utilities Commission
State Capital, 500 E. Capital Avenue
Pierre, SD 57501-5070

Lorraine Kenyon
Alaska Public Utilities Commission
1016 West Sixth Avenue, Suite 400
Anchorage, AK 99501

Debra M. Kriete
Pennsylvania Public Utilities Commission
P.O. Box 3265
Harrisburg PA 17105-3265

Mark Long
Florida Public Service Commission
2540 Shumard Oak Blvd.
Gerald Gunter Building
Tallahassee, FL 32399-0850

Samuel Loudenslager
Arkansas Public Service Commission
P.O. Box 400
Little Rock, AR 72203-0400

Sandra Makeeff
Iowa Utilities Board
Lucas State Office Building
Des Moines, IA 50319

Philip F. McClelland
Pennsylvania Office of Consumer Advocate
1425 Strawberry Square
Harrisburg, Pennsylvania 17120

Michael A McRae
D.C. Office of the People's Counsel
1133 15th Street, NW -- Suite 500
Washington, DC 20005

Terry Monroe
New York Public Service Commission
Three Empire Plaza
Albany, NY 12223

Lee Palagyi
Washington Utilities and Transportation Commission
P.O. Box 47250
Olympia, WA 98504-7250

James Bradford Ramsay
National Association of
Regulatory Utility Commissioners
1201 Constitution Avenue, N.W.
Washington D.C. 20423

Brian Roberts
California Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102-3298